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SUBJECT: IMF'S MISSION TO MOSCOW

Classified By: ECON MC Eric T. Schultz, Reasons 1.4 (b/d).

¶1. (C) Summary. IMF Senior Resident Representative for Russia Odd Per Brekk gave us an overview of the recent Article IV consultations with the GOR. He explained that non-vital spending comprised too much of the country's 2009 fiscal deficit. Right-sizing the deficit and directing more of the de facto stimulus toward infrastructure would support modernization objectives, put some teeth in the rhetorical war on corruption and leave more resources for 2010 when the GOR's spending needs might be more compelling. Brekk also noted that the declining quality in bank assets meant the Central Bank (CBR) needed to improve its supervision, thereby giving the GOR more flexibility in its policy response. He said the IMF would also recommend shifting the focus of monetary policy away from exchange rate targeting to inflation targeting. Brekk also emphasized that the ruble was a long way from being a reserve currency, but that such a goal had the potential of compelling the GOR to focus on long-term objectives such as modernization and fiscal discipline when addressing its current, crisis-driven short-term objectives. End Summary.

Fiscal Policy: Adjust Composition of Stimulus

¶2. (C) On May 21-June 1, an IMF mission conducted the annual Article IV consultation with the GOR. Discussions focused on the effects of the global economic crisis on the Russian economy and the GOR's policy response. The IMF mission met with First Deputy Prime Minister Shuvalov, Finance Minister Kudrin, Central Bank Governor Ignatiev, other senior officials, and representatives of financial institutions, corporations and think tanks. IMF ResRep Brekk briefed us on the highlights of Article IV visit.

¶3. (C) Brekk said the visiting IMF representatives had criticized the composition of the GOR's stimulus plan, which Brekk said was the largest anti-crisis package among G20 nations as a percentage of GDP. However, Brekk said the budget had committed too many precious resources to non-vital spending. Inefficient and non-transparent outlays on defense and national security had remained largely intact but infrastructure and social spending had been cut, with greater stimulatory effect and despite the poverty relief they had the potential to provide. Brekk said the World Bank had observed correctly that not enough was targeted on social spending. Although the IMF's main concern was not social justice but macroeconomic stability, they nevertheless thought the GOR had gotten this one wrong.

¶4. (C) Brekk also argued that the GOR's foregoing of previously planned infrastructure projects had helped save

current-year budget resources but also served to postpone an array of much-needed improvements and was another lost opportunity to stimulate the economy. According to Brekk, this year would have been a suitable time to begin modernizing the country's transportation, communication and education networks; enhancing budgetary control of infrastructure expenditure management; and addressing the official corruption and contractor fraud that have tended to raise the cost of such projects. According to Brekk, the fiscal policy decision to postpone infrastructure reform had short-changed much of what President Medvedev pledged to achieve shortly after his inauguration last year.

15. (C) Brekk said in the IMF's view, the GOR could run a smaller and more efficient deficit by focusing on spending more on the social sector as well as infrastructure investments. A smaller deficit this year would allow the GOR to run a bigger deficit next year when it may actually be more important. Brekk said he expected the GOR would strive for a deficit that would ultimately be smaller than the \$90 billion target outlined in the revised 2009 federal budget. In this scenario, the Finance Ministry would exert its influence to control actual spending and would ensure funding for those areas it considered priorities. Brekk noted the GOR's ability to borrow to cover the deficit would be limited at best, but aiming for lower overall expenditures would help conserve Reserve Fund resources for 2010, when the budget could be even more constrained.

Monetary Policy: Stress Tests and Inflation Targeting

16. (C) Brekk said the IMF had also recommended the Central Bank (CBR) conduct rigorous and comprehensive stress tests of the banking sector. Brekk said the IMF team was disappointed in the CBR's lack of information on the state of banks' assets. The stress tests would serve as a starting point on the road to improved supervision which would not only alert senior CBR officials about the sector's condition but would also give policymakers more flexibility in their efforts to respond to expected waves of crises.

17. (C) Brekk commended the GOR's earlier efforts to provide liquidity to the country's larger banks but contended that the situation was worsening again and the CBR and the Deposit Insurance Agency (DIA) needed to develop a plan for helping banks manage their deteriorating assets. The GOR's current mechanism for supporting the banking sector was entirely ad hoc, and it was straining the CBR's and DIA's resources. According to Brekk, a systematic approach was needed that would identify which banks could survive and which banks would either fail or become acquisition targets. This would alleviate some of the pressure on officials to treat every distressed bank as the straw that might break the camel's back.

18. (C) Brekk said the IMF believes the CBR should also begin moving convincingly toward inflation targeting and away from exchange rate targeting. He said he appreciated the difficulty of Russia's economic straits. The strengthening ruble on the back of rising oil prices was quashing any hope the country may have had for exporting its way back to recovery, as had been the case in 1998. However, he maintained that targeting inflation was the kind of difficult decision the country needed to make now to spur the economy toward improved efficiency and enhanced competitiveness going forward.

Ruble as Reserve Currency: an Idea Worth Pursuing

19. (C) Brekk told us that Russia's stated goal of transforming the ruble into a reserve currency was of course nonsense but suggested that it could nonetheless serve as a guide for making difficult policy decisions. According to Brekk, the transformation from the ruble's present status to that of a reserve currency would require, among other things, greater economic integration, an improved investment climate,

a more transparent government and sound financial institutions. In short, all the things we in the West had been urging the GOR to do with respect to economic reforms.

Comment

¶12. (C) Brekk's point of view on the ruble as a reserve currency is one we should consider. Rather than dismissing the GOR's aspirations or reacting to the rhetorical provocation, perhaps we should encourage them. A drive to make the ruble a reserve currency could provide an impetus for the GOR to carry out the long-term reforms we have long urged. End Comment.
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